No. 22,188-A

United States Court of Appeals

For the Ninth Circuit

In the Matter of
E. W. Reynolds Company,
Bankrupt.

Beverly McConnell, and Oscar Strobel, Trustee of the Estate of E. W. Reynolds Company,
Appellants,

vs.

Estate of W. H. Butler, Deceased, Certain Debenture Holders,
Appellees.

On Appeal from the United States District Court for the District of Arizona

BRIEF FOR APPELLANT, OSCAR STROBEL, TRUSTEE OF THE ESTATE OF E. W. REYNOLDS COMPANY, BANKRUPT

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PERNAU-WALSH PRINTING CO., SAN FRANCISCO, CALIFORNIA

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JURISDICTIONAL STATEMENT

This is an appeal by Oscar Strobel, Trustee of the Estate of E. W. Reynolds Company, a Bankrupt, from a judgment of the United States District Court for the District of Arizona, entered in proceedings to review an order of the Referee in Bankruptcy of that

Court. The judgment appealed from was entered on the 26th day of June, 1967.

The District Court had jurisdiction of the review proceedings by virtue of Section 1334 of the Judicial Code, 28 U.S.C. Jurisdiction of this appeal exists under and by virtue of Sections 1291 and 1292 of the Judicial Code, Title 28, U.S.C. and Section 24 of the Bankruptcy Act, Title 11, U.S.C. 47.

Notice of appeal from the judgment of the District Court was filed on the 3rd day of July, 1967, within the time prescribed by law.

STATEMENT OF THE CASE

This proceeding arises out of an involuntary bankruptcy proceeding, filed in the United States District Court for the District of Arizona. Appellant, as Trustee, filed objections to claims of various creditors, including a class or group of claimants referred to by Court and counsel throughout the proceedings as "debenture claimants." The objection to the debenture claims was that, "For all practical and equitable purposes the debenture claimants represent proprietary rather than creditor interests, said debentures having arisen out of a debenture-stock exchange plan, and that, therefore, they are in the nature of claims of stockholders and can neither legally nor equitably share in dividends of this estate until payment in full of true creditors." (Specification of Objection, p. 77.)*

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*References in parenthesis are to Record on Appeal.

The Referee in Bankruptcy denied the Trustee's objection and held that such claims should be allowed "on a parity with all other general unsecured claims." (Referee's Finding of Facts, p. 101.)

A petition for review was filed by the Trustee and on filing of the Certificate on Review, objection was made by the Trustee to the insufficiency of the Record certified by the Referee to the District Judge. The objections to the sufficiency of the Record and the petition for review were heard on April 7, 1967. On June 26, 1967, the District Judge entered an order denying the Trustee's objections to the sufficiency of the Record, adopting the Finding of Facts and Conclusions of Law of the Referee, denying the Trustee's objections to the claims and ordered that they should be allowed.

THE FACTS

(Reference to facts hereafter will be limited to facts found in the Record as certified by the Referee to the District Judge. Unfortunately, that Record is not complete. It did not contain a transcript of the evidence presented at the hearing nor summary thereof. It contained rather only a summary of those facts which supported the Referee's findings. In addition, it did not include the claims which were in issue or other claims filed in the estate, although the Referee referred thereto in his Finding of Facts and Conclusions of Law. The amounts, status, and nature of the claims which have been allowed, both

by debenture claimants and true creditors of the estate, are material considerations in this controversy.)

The E. W. Reynolds Company was a California corporation engaged in the wholesale jewelry business. Over the years of its operation a plan existed by which employees could purchase stock in the corporation. In October 1956 there were 1615 shares of stock in the corporation owned by employees, each share having a par value of $100.00. (Finding of Fact I, p. 97, and Ex. #1.) The employees had paid $240.00 per share for the stock, and some employees were also obligated on interest-bearing stock subscription agreements on which they were making payments by application of dividends received from the company. (Referee's Certificate, p. 1.)

Records of the company reflect that at least as far back as 1952 the company had been undergoing financial problems. No dividends were paid to stockholders between 1952 and 1956. (Finding of Fact II, p. 97, and Ex. #1.) As conditions grew worse, the company yielded to pressure brought to bear by substantial creditors and revamped its total operations, including the curtailment of the California business. The employee-stockholders also expressed dissatisfaction in that they were receiving no return on their stock investments and further were unable to make payments on the subscription agreements because of lack of dividends. (Ex. #16.) In October of 1956 the company filed an application with the California Di-

vision of Corporations requesting a permit to issue and sell debentures to these employee-stockholders. (Ex. #1.) The application recited:

> "Many of the employees who purchased stock were paying for the stock and had anticipated paying therefor through the application of dividends towards the purchase price. Also many of said employee-purchasers are not in a financial position to make payment on the purchase price of their stock in the absence of such dividends and interest on such dividends and interest on such obligations has continued to accrue. Applicant is informed, believes, and therefore states that many of such employee-purchasers desire to be released from their obligations to continue paying on the purchase price of shares and from the accruing interest on the balance thereof, and in lieu of shares in applicant such employees desire to have an obligation providing for a definite and known return rather than uncertainties of dividends . . ."

The California Division of Corporations did issue its negotiating permit. (Ex. #6.) Pursuant to the permit the company forwarded its letter of December 28, 1956 (Ex. #16) to the employee-shareholders explaining the plan. The letter reflected the company's financial difficulties and inability to pay dividends. It acknowledged that this had resulted partly from too generous dividends in previous years and "some unprofitable periods of operation in recent years; however, the major cause has been the need for more and more working capital." It also ex-

pressed the financial condition of the company would not permit dividends, "for many years to come." A form of commitment accompanied the letter explaining that for those employees wishing to participate, the corporation would issue debentures having a face value of $100.00, bearing interest at the rate of six per cent (6%) per annum, with the first interest payable on May 31, 1957, and the principal of the debentures to mature serially over a period commencing May 31, 1963, and ending May 31, 1970; that all shareholders wishing to participate could receive two and one-half (2½) debentures for each share of stock held by them. Commitments were received from the employee-stockholders involved, and upon supplemental application to the California Division of Corporations the latter issued its permit to "sell and issue" debentures (Ex. #8) in March of 1957. Debentures with a total face value of $244,800.00 were issued and deposited in escrow with the California Bank. The shares of stock by the employees desiring to participate in the plan were surrendered to the company and cancelled. (Finding of Facts #IV, p. 97, Ex. #10 and Ex. #17.)

We refer the Court to Exhibits #11 and #14 which contain financial statements for the company for the fiscal years ending May 31, 1956, 1957 and 1958. For the convenience of the Court we herewith also submit a chronological summary of the events leading up to the debenture issue, and the ultimate bankruptcy of the company, as reflected by those statements:

May 31, 1956—This is the end of the fiscal period immediately preceding the issuance of the debentures. The company sustained an operating loss of $46,-674.53. The statement also reflects the company contemplates further substantial expenses because of a planned move of its headquarters during the next fiscal period. The statement shows an earned surplus of $1,004,374.30. This is the figure reported to the California Division of Corporations in the application for authority to issue debentures. This figure was glaringly inaccurate, however, because the company had never entered on the books the cost of reacquiring capital stock for approximately the last 9 years.

March 1, 1957—Debentures with total face value of $244,800.00 are issued.

June 1, 1957—This is two months after the debenture issue. Retained earnings are now down to $387,491.45 because the adjusting entry of $969,528.89 has been made on the books to reflect the repurchase of stock since 1947. This does include the debenture issue also.

May 31, 1958—The statement reflects net loss for that year of $972,388.96. This includes the loss resulting from the curtailment of the company's operations. The San Francisco store has been closed completely. Los Angeles is reduced to a division, and the company is in the course of concentrating its total operation in Phoenix, all of these having been contemplated at the close of the 1956 fiscal period. The loss

reduced the earned surplus by this time to a deficit of $584,897.51. All of this occurred within slightly more than one year from the time the debentures are issued.

May 1957 until May 1963—Interest totaling $77,-112.00 (Ex. #10) is paid on the debentures. The first principal payment of $33,700.00 falls due in May 1963. That payment, together with the interest payment of $14,688.00 for that year cannot be paid.

June 3, 1963—Involuntary Petition in Bankruptcy filed by "trade" creditors. Retained earnings as of January 31, 1963, was a deficit of $1,005,984.40. (Ex. #12.) Retained earnings as of July 3, 1963, was a deficit of $1,065,287.19. (Ex. #13.)

Claims of creditors filed and allowed by the Referee include charges preceding the debenture issue. (Ex. #14.) With only nominal exception, all of the debenture claimants herein were original debenture holders. (Ex. #10.)

QUESTIONS PRESENTED

1. Are debentures of a corporation issued in payment of repurchase price of stock of the corporation "provable debts" within the meaning of the Bankruptcy Act, entitling the holders thereof to share in payment of dividends with creditors of the estate?

2. Must payment of dividends to holders of debentures issued by a corporation in payment of repurchase price of that corporation's stock be sub-

ordinated to payment of creditors where the issuing corporation was insolvent or rendered insolvent by virtue of their issue, or, where the corporation is insolvent at the time the payment is to be made, or, where there are insufficient funds or assets with which to pay both the debentures and creditors of the corporation?

SPECIFICATION OF ERRORS

1. The District Court (and the Referee in Bankruptcy) erred in holding that the debentures of the E. W. Reynolds Company issued to evidence the purchase price due for the stock repurchased by the corporation were provable debts within the meaning of the Bankruptcy Act entitling the holders thereof to share in dividends in the estate.

2. The District Court (and the Referee in Bankruptcy) erred in finding that claims upon debentures issued by the bankrupt corporation, evidencing the repurchase price of its own stock, should not be subordinated to the payment of creditors of the estate, where the issuing corporation was in financial distress at the time of the issuance, the debenture claimants were aware of such financial distress at the time they agreed to exchange their stock for the debentures, where both creditors existing at the time of the debenture issue and future creditors were factually prejudiced by the issuance, where there are insufficient funds or assets with which to pay the debentures at the time the payment therefor became

due, and where there is factually no surplus or retained earnings at such time.

3. The District Court (and the Referee in Bankruptcy) erred in finding:

(a) That the employee-stockholders had no reason to believe that the E. W. Reynolds Company was insolvent in October of 1956. (Finding of Fact IX.) The Court should have found that the employee-stockholders were well aware of the financial distress, in that they had received no dividends for the preceding years, and that they were expressly advised of the financial problems of the company and that there would be no dividends for "many years to come." (Ex. 16.)

(b) That there was no evidence that any claims of other general unsecured creditors were created prior to May of 1957. (Finding of Fact XIII.) The Court should have found that the claims of creditors had been filed in the estate and allowed which were for obligations incurred prior to March of 1957.

(c) That the insolvency and the bankruptcy of the corporation were attributable to causes other than that of the creation of the debenture obligation. (Finding of Fact XI.) The Court should have found that the issuance of the debentures was a substantial, if not the ultimate, cause of the filing of the Involuntary Petition in Bankruptcy by the trade creditors, in that the inability of the corporation to pay the first

principal payment due on the debentures in May of 1963 occasioned the filing of the Involuntary Petition in Bankruptcy in June of 1963.

(d) That the capitalization of the company at the time of the debenture issue was adequate and not nominal. (Finding of Fact VIII.) The Court should have found that the capitalization of the company was inadequate; that it was the cause of the revamping of the company's operation and curtailment of its California operation, as well as the withholding of dividends to stockholders for the preceding four-year period; and that although a surplus is reflected on the balance sheet at the time of the issuance of the debentures, the entry is inaccurate, failing to reflect the substantial adjustments to surplus for transactions which had occurred in the previous nine-year period; in addition, that there were conditions then in existence, which, upon culmination, would severely affect the financial condition of the company; that if the company was not insolvent at that time, its solvency was doubtful, and dependent upon conditions then in existence, which ultimately did result in insolvency.

SUMMARY OF ARGUMENT

The Trustee's objections to the claims of the debenture holders is two-fold: first, that these claims do not represent "provable debts" within the meaning

of the Bankruptcy Act; and second, that even if they are "provable debts" equity requires that they be subordinated to payment of other claims. The distinction between disallowance and subordination of claims in bankruptcy is succinctly stated by *Herzog & Zweibel,* in their treatise "The Equitable Subordination of Claims in Bankruptcy," 15 Vanderbilt Law Review 83, pp. 85-87:

> "Before launching into a discussion of the nature, cause and effect of equitable subordination some mention should be made of the distinction between outright disallowance of a claim and the subordination thereof to the claims of others. There seems to be an inadvertent confusion of the concepts of disallowance of the claim and postponement or subordination of it . . .
>
> "Disallowance of a claim negates its validity and existence completely and ousts the claimant from creditor status for all purposes. The claim should be rejected and disallowed, it seems to us, when it has no basis in fact or law, is nonexistent or is illegal. Equitable jurisdiction should not be exercised when there is a full, adequate and complete remedy at law. Subordination should be ordered when the claimant is undeniably a creditor, but for reasons of equity should be relegated to a rank inferior to that of general creditors.
>
> "The jurisdiction to disallow claims on legal grounds is derived directly from the act. Only in subordinating or postponing claims does the court exercise its inherent equitable powers. In all these cases the court proclaims itself a court of equity with the power to do equity—but relief

in equity is remedial and not penal. Disallowance of a valid legal claim because of misconduct obnoxious to a court of equity is certainly penal in nature. If under the cardinal principles of equity a creditor is not entitled to share ratably with other creditors, then it seems clear that the proper remedial relief is postponement of payment to him until all others have been paid in full."

ARGUMENT

I.

DEBENTURES ISSUED TO EVIDENCE SUMS DUE BY A CORPORATION FOR REPURCHASE OF ITS OWN STOCK ARE NOT "DEBTS" ENTITLING THE HOLDERS THEREOF TO SHARE DIVIDENDS IN BANKRUPTCY WITH THE CORPORATION'S CREDITORS.

Section 63 of the Bankruptcy Act, Title 11, Chap. 7, Sec. 103, provides "debts of the bankrupt may be proved and allowed against the estate . . ." Filing of a claim, however, does not automatically entitle the claimant to share in dividends. Section 47(8) of the Act, Title 11, Chap. 5, Sec. 75, makes it incumbent upon the Trustee to "examine all proofs of claim and object to the allowance of such claims as may be improper . . ." It is therefore axiomatic that claims which are not "debts" of the bankrupt are not "provable" and cannot be allowed. Obviously, a claim filed by a stockholder of a bankrupt corporation for repayment of money invested in the company, and evidenced by a stock certificate is not a "provable debt" nor "allowable claim." That the stock certificate

may have been exchanged for a note, a debenture, or a contract to repurchase, does not change the nature of the claim. The Court shall, and must, look beyond the form of the claim, to determine the true nature of the transaction. *Herzog & Zweibel,* supra, at p. 93, makes this clear:

> "The so-called capital contribution cases have invariably been treated as a sub-classification within the general sphere of equitable subordination claims. In these cases, an alleged debt is transformed by the Bankruptcy Court into what it deems to be the essential nature of the transaction, to wit: A capital contribution or other proprietary interest.
>
> Several courts relying on Pepper v. Litton have failed to see that these cases actually turn upon the existence or non-existence of the debt and not upon the question of whether the courts will subordinate the claims.
>
> Actually, however, our perspective will be sharpened if we focus on the sole question involved here, that is whether the claim is as a matter of substantial economic and legal reality and indebtedness or whether it is proprietary interest. *Once the judicial investigation has determined that the claim is not in fact a debt but is a proprietary interest, subordination follows as a matter of course,* for the essential nature of a capital interest is a fund contributed to meet the obligations of a business which is to be repaid only after all other obligations have been satisfied." (Emphasis supplied by the writer.)

The debenture claims are "as a matter of substantial economic and legal reality" claims for repayment of capital or proprietary investments. The debenture-stock exchange plan was nothing more than an agreement by which the corporation agreed to repurchase its own stock, the purchase price being evidenced by the debenture certificates (promissory notes). The volume of cases denying claims of stockholders in bankruptcy on just such agreements is overwhelming. In 9 A.L.R. 1296-1298, the rule is summarized:

> "Apparently as an outgrowth of the trust fund doctrine, it is consistently held that where a stockholder sells or agrees to sell its stock to the corporation and the corporation is thereafter adjudicated a bankrupt, the stockholder is not entitled to prove his claim for the price or on the contract against the estate in competition with creditors, for it is entitled to compensation only in case a surplus remains after all creditors have been paid." (See also *Hamor v. Taylor-Rice Eng. Co.,* 84 F. 392; *Re: S. P. Smith Lumber Company,* 132 F. 618; *Graselli Chemical Co. v. Aetna Explosives Company,* 258 F. 66; *Re: Brueck & W. Company,* 258 F. 69; *Re: O'Gara & McGuire,* 259 F. 935; *Ohlmstead v. Vance & J. Company,* 63 N.E. 634; *Clark & E. C. Clark Mach. Co.,* 115 N.W. 416; *Inland Gas Corporation,* 92 F.Supp. 810; *In Re Semolino Macaroni Company,* 109 F.Supp. 453.) (See also: 3 *Collier on Bankruptcy,* 1781; annot. in 47 A.L.R. 2d 758.)

Very definite rules govern the repurchase by a corporation of its own stock:

"The majority of the American courts have taken the view that a solvent corporation may lawfully purchase and hold its own stock without express authority in the absence of express instructions, provided it acts in good faith and without prejudice to rights of creditors and has a surplus with which to make the purchase." (*Fletcher on Corporations,* Vol. 6A, No. 2848.)

The existence of surplus is essential. This rule has also been expressly codified in both Arizona and California. (West's California Annotated Codes, Corporations No. 1705-07; Arizona Revised Statutes, 10-196.) (*Cutter Labs., Inc. v. Twinning,* 34 California Reports 317, 221 C.A. 2d 302; *Tiedje v. Aluminum Taper Mill,* 296 Pac.2d 554 (Calif.).)

Collier on Bankruptcy, Vol. 3, 1781-92, states:

"Unless forbidden by the laws of the state of incorporation, or by its own charter or by-laws, a corporation may (according to the view prevailing in this country, as distinguished from the English doctrine) agree to purchase or repurchase its own stock, and no creditor may object, provided that the corporation at the time when the agreement was made was solvent, and that it pays the purchase price out of its surplus. This latter requirement is important and is the gist of the trustee's defense in bankruptcy liquidation. Notwithstanding the validity of an agreement to purchase or repurchase the enforceability of such an agreement is always conditioned upon availability of a surplus." (Accord in *Re: Tichenor-Grand Co.,* 203 F. 720; *Boggs v. Fleming,* 66 F.2d 859; *Matter of Atlantic Printing Com-*

pany, 60 F.2d 553; *Matter of Penfield Distilling Company,* 131 F.2d 694.)

The validity of the agreement by which the E. W. Reynolds Company agreed to issue debentures for surrender of its stock is therefore dependent upon a finding that the company was solvent at the time of the agreement.

Enforceability (as opposed to validity) of the agreement is further dependent on a finding that there now exists a surplus from which payment can be made.

The financial statements of bankrupt do not permit a finding that it was solvent in March of 1957. They indicate, rather, that the company was then, and had been for sometime, in dire financial condition—that it was reorganizing its entire operation in an attempt to maintain its operation, and that the condition was obvious to everyone, including its employee-stockholders. And, of course, there is no factual dispute that the company was insolvent at the time the first payment of principal on the debentures fell due, and that it is insolvent now.

The rationale of the rule prohibiting allowance of the debenture claims is well stated in *Re: Atlantic Printing Co.,* 60 F.2d at page 554:

> "Therefore, while it is proper for a solvent corporation to contract to purchase its own stock, the right of a stockholder to enforce the contract is conditioned upon the ability of the corporation to make payment without infringing upon the

protected rights of the other stockholders and creditors. This point arises in Re: Fechheimer, Fishel Company, 212 F. 357, 363, and the court said: 'If a stockholder sells his stock to a corporation which issued it, he sells it at his peril and assumes the risk of a confirmation of the transaction without encroachment upon the funds which belong to the corporation in trust for the payment of its creditors.'

Thus, the solvency of the corporation at the date of the inception of the contract is not determinative of its enforceability. Even though solvent at that time, the contract cannot be performed if performance would imperil those assets on which the creditors have a superior lien. Keith v. Kilmer, 261 F. 733, 9 A.L.R. 1287. In Re: Fechheimer, Fishel Company, *supra* . . .

To allow the present claim would be to repudiate a long-recognized doctrine that capital stock constitutes a trust fund for the benefit of the corporate creditors. Handley v. Stutz, 139 U.S. 417, 11 S.Ct. 530, 35 L.Ed. 227; Upton v. Tribilcock, 91 U.S. 45, 23 L.Ed. 203; Sawyer v. Hoag, 17 Wall. 610, 21 L.Ed. 731. Stockholders are conclusively presumed to know of the trust character of this fund and that all dealings in respect thereto are subject to whatever equities are attached to the fund. To enforce performance of this contract would have the further effect of transforming a stockholder into a creditor and would permit him to share equally and in competition with the other creditors. It is already well established that a shareholder is not a corporate creditor. Warren v. King, 108 U.S. 389, 2 S.Ct. 789, 27 L.Ed. 769; and he does not by virtue of

the contract to repurchase stock cease to be a stockholder and become a creditor." (*Hazel Atlas Glass Company v. Van Dyke and Reeves,* 8 F.2d 716; *Keith v. Kilmer,* 261 F. 733; *Mathews Bros. v. Pullen,* 286 F. 827.)

See also the Fifth Circuit holding in *Robinson v. Wangerman,* 75 F.2d 757.

II.

CLAIMS OF STOCKHOLDERS WHO HAVE EXCHANGED THEIR STOCK FOR DEBENTURES MUST BE SUBORDINATED IN BANKRUPTCY TO CLAIMS OF CORPORATE CREDITORS.

The equitable powers of the Bankruptcy Courts to subordinate claims is not disputed, and there are more than sufficient reasons here why the debenture claims must be subordinated to payment of other claims allowed in the estate. The debenture claimants originally advanced money purely as an investment, whereas trade creditors advanced merchandise and other property of value, with the full expectation of payment in full. The debenture holders did not contemplate withdrawal of their investment, at least until creditors had been paid. Subordination is nothing other than what they originally agreed upon. They should not be permitted to change their position to the detriment of the corporate creditors. While the motives of the debenture claimants may have been very honorable, their election to convert their holdings to debenture certificates has also worked to their benefit—they have already recovered nearly

one-third (⅓) of their original investment by the interest payments made to them. They were fully aware of the company's financial distress at the time of the agreement, and whether they kept their stock, or exchanged it for debentures, they realized that liquidation of their investment was contingent upon the company weathering the financial storm. They merely substituted an attempt to recover their investment plus approximately a one-third (⅓) realization thereof for the uncertainties of dividends and the possible loss of their total investment. The withdrawal of funds to make the interest payments has, of course, only aggravated the company's problems, decreasing already short operating capital.

CONCLUSION

The claims of the debenture holders are nothing more than the claims of stockholders for payment of funds they invested in the company. They cannot be allowed, when the corporation is insolvent, and there are insufficient funds to pay creditors.

In addition, the debentures themselves are unenforceable under the laws of both Arizona and California, where the transactions occurred. Had suit been filed against the corporation to compel payment, without the intervention of bankruptcy, the absence of surplus with which to make payment would have been an absolute defense. The Involuntary Petition in Bankruptcy was filed just for the purpose of

avoiding such litigation or the possible withdrawal of the company's assets.

These claims cannot, therefore, either legally or equitably, share in the distribution of assets of the estate, and we respectfully request that the judgment of the District Court be reversed, that the debenture claims be disallowed, or wholly subordinated to payment of claims that have been properly allowed in the estate.

Dated, Phoenix, Arizona,
December 6, 1967.

Respectfully submitted,
BEVERLY J. MCCONNELL,
Attorney for Appellant,
Oscar Strobel.

CERTIFICATE OF COUNSEL

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

BEVERLY J. MCCONNELL,
Attorney for Appellant,
Oscar Strobel.